

1984

Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action

Gary Walters

Follow this and additional works at: <https://ir.lawnet.fordham.edu/flr>



Part of the [Law Commons](#)

Recommended Citation

Gary Walters, *Repurchase Agreements and the Bankruptcy Code: The Need for Legislative Action*, 52 Fordham L. Rev. 828 (1984).

Available at: <https://ir.lawnet.fordham.edu/flr/vol52/iss5/5>

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Law Review by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.

REPURCHASE AGREEMENTS AND THE BANKRUPTCY CODE: THE NEED FOR LEGISLATIVE ACTION

INTRODUCTION

In May 1982, the spectacular failure of Drysdale Government Securities, Inc. (Drysdale) rocked the government securities markets.¹ Drysdale was a participant in the highly-sophisticated repurchase market,² and its default raised the long-dormant issue whether a repurchase agreement (repo) is a sale or a secured loan.³ A repurchase agreement consists of a sale of a security coupled with a simultaneous

1. See Bennett, *Securities Firms and the Risk of Failure*, N.Y. Times, May 19, 1982, at D4, col. 1; Wall St. J., May 19, 1982, at 2, col. 1. Drysdale defaulted on an approximately \$300 million payment of accrued interest on government securities held pursuant to repurchase agreements. *Disturbances in the U.S. Securities Market: Hearing on Recent Developments in the U.S. Government Securities Markets Arising from Default by Drysdale Government Securities, Inc. Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 97th Cong., 2d Sess. 1 (1982) (remarks of Sen. D'Amato, Subcomm. Chairman) [hereinafter cited as *Senate Hearing*]; Welles, *Drysdale: What Really Happened*, Institutional Investor, Sept. 1982, at 73.

Government securities consist of Treasury obligations, United States government securities and United States government-sponsored securities. See Investment Company Act of 1940, 15 U.S.C. § 80a-2(a)(16) (1982). The government securities market is one of the largest capital markets in the world. Welles, *supra*, at 74; see W. Sharpe, *Investments* 193 (1978) ("U.S. Treasury is omnipresent in the capital market"). The market may be broken down into the primary market for the sale of new issues, the secondary market for trading, and the repurchase market in which the securities essentially serve as collateral for short-term loans. See *Senate Hearing*, *supra*, at 3-4 (testimony of Mark Stalneck, Deputy Ass't Sec'y for Fed. Fin., Dep't of the Treasury).

2. Welles, *supra* note 1, at 81; Wall St. J., May 19, 1982, at 2, col. 1. Although Drysdale was a recent entrant in the market, the firm was able to use its capital base of \$20.8 million to create gross positions as high as \$20 billion. Welles, *supra* note 1, at 79, 81. The specific market practice that led to Drysdale's default related to the pricing of securities obtained in a transaction. The firm utilized "flat pricing" which does not include in either the original or the repurchase price the interest accrued on the securities between coupon dates. *Id.* at 80. The suppliers of securities, therefore, extended too much margin. In effect, Drysdale was able to receive a \$300 million unsecured loan. *Id.* at 74. Drysdale used this money to cover its trading losses. See *id.* at 80. In response to the Drysdale failure, common practice has shifted to include accrued interest in the pricing. M. Stigum, *The Money Market* 402-03 (rev. ed. 1983); Public Securities Association, *A Survey of the Repurchase Agreement Market* 8 (1982) [hereinafter cited as *PSA Survey*].

3. See *Bankruptcy Reform: Hearing on Northern Pipeline Co. v. Marathon Pipeline Co. Decision; Consumer Credit Code Amendments; Agricultural Produce Bailment Amendments; Repurchase Agreement Code Amendments; Shopping Center Tenancy Amendments; and Timesharing Agreements Amendments Before the Subcomm. on Courts of the Senate Comm. on the Judiciary*, 98th Cong., 1st Sess. 517-18 (1983) (statement of Investment Company Institute) [hereinafter cited as *Bankruptcy*

agreement by the original seller to repurchase the security at a later date for a specified higher price.⁴ Although the parties to a repo typically characterize it as a sale,⁵ it may be viewed as a secured loan⁶ for the period between the sale and the repurchase with the price differential considered interest⁷ and the security considered collateral.⁸

Reform Hearing]; Welles, *supra* note 1, at 74, 78; Golub, Eisenberg & Hoene, Memorandum to the Investment Company Institute, Bankruptcy Implications for "Repo" Transactions 1-2 (Aug. 3, 1982) (default raised questions about legal status) (available in files of *Fordham Law Review*) [hereinafter cited as Bankruptcy Implications]; Letter from Rep. Benjamin S. Rosenthal, Chairman, Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations, to Hon. John Shad, Chairman, Securities and Exchange Comm'n 3-4 (June 15, 1982) (same) (available in files of *Fordham Law Review*) [hereinafter cited as Rosenthal Letter]; Letter of Thomas Russo, Esq., to Paul A. Volcker, Chairman, Federal Reserve Board 2 (June 4, 1982) (available in files of *Fordham Law Review*) [hereinafter cited as Russo Letter]. Market participants deliberately left the issue unresolved allowing them to characterize the repo to suit their purposes. M. Stigum, *supra* note 2, at 398. For example, state and local governments may have the authority to buy and sell securities, but not to borrow or lend funds. *See id.* at 422; Memorandum of Dauphin Deposit Bank & Trust Co. in Opposition to the Debtor's Application for Injunctive Relief and in Support of its Crossclaim for Declaratory Judgment at 5, 12, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Sept. 15, 1982) (evading restrictions on loans with private parties) [hereinafter cited as Dauphin Memorandum]. These governmental units would therefore be inclined to characterize a repo as a sale. *Id.* at 3-5. Thrift institutions, on the other hand, would characterize a repo as a loan so that they would not have to mark down the book value of the securities to market value. Application for Order Approving Settlements of Outstanding Reverse Repurchase Agreements Between Lombard-Wall, Inc. and Talman Home Federal Savings & Loan Ass'n of Illinois, St. Paul Federal Savings & Loan Ass'n of Chicago, Dry Dock Savings Bank and Midwest Federal Savings & Loan Ass'n of Minneapolis at 3, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Sept. 15, 1982).

4. First Nat'l Bank v. Estate of Russell, 657 F.2d 668, 669 (5th Cir. 1981); *In re Legel, Braswell Gov't Sec. Corp.*, 648 F.2d 321, 324 & n.5 (5th Cir. 1981); *Cosmopolitan Credit & Inv. Corp. v. Blyth Eastman Dillon & Co.*, 507 F. Supp. 954, 956 (S.D. Fla. 1981); *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); M. Stigum, *supra* note 2, at 41; Bankruptcy Implications, *supra* note 3, at 2.

5. Hirschberg, *Issues Which Frequently Arise In Structuring and Documenting Commercial Repurchase Transactions*, in Practising Law Institute, *Repurchase and Reverse Repurchase Agreements* 213, 215 (1982) (Course Handbook Series No. 290). *See infra* notes 50-53 and accompanying text.

6. Extract of Minutes at 3, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Sept. 16, 1982, 6 P.M.); M. Stigum, *supra* note 2, at 417; Bankruptcy Implications, *supra* note 3, at 20.

7. S. Goldfeld & L. Chandler, *The Economics of Money and Banking* 462 (8th ed. 1981); L. Ritter & W. Silber, *Principles of Money, Banking, and Financial Markets* 118 n.1 (3d ed. 1980); *see* Bankruptcy Implications, *supra* note 3, at 20.

8. *See* L. Ritter & W. Silber, *supra* note 7, at 118 n.1; M. Stigum, *supra* note 2, at 417; Welles, *supra* note 1, at 78; Bankruptcy Implications, *supra* note 3, at 20. *See infra* note 31 and accompanying text.

In October 1982, Lombard-Wall, Inc., another securities dealer, failed and a bankruptcy court ruled that a repurchase agreement is a secured loan and the securities are merely collateral.⁹ Accordingly, when an original seller of securities goes bankrupt, the securities are property of the estate-in-bankruptcy,¹⁰ and under the Bankruptcy Code's (Code) automatic stay provision, these securities cannot be sold to satisfy the security interest.¹¹ This inability to liquidate subjects the bankrupt's counterparty, the original purchaser of the securities, to the risk of principal and interest loss, substantial illiquidity, and even bankruptcy.¹² These effects could easily spread and severely disrupt the market.¹³

9. Extract of Minutes at 3, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Sept. 16, 1982, 6 P.M.); see *Bankruptcy Reform Hearing*, *supra* note 3, at 337 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); PSA Survey, *supra* note 2, at 2. The counterparties to the transaction had threatened to liquidate the securities. Application for Order Prohibiting Disposal of Securities Under Repurchase Agreements and Investor Agreements at 1, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Aug. 13, 1982) [hereinafter cited as Application Order]. Accordingly, Lombard-Wall requested a temporary restraining order. *Id.* The court granted this request. *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Aug. 17, 1982) (temporary restraining order).

10. See *infra* note 31 and accompanying text.

11. 11 U.S.C. § 362(a)(4) (1982). See *infra* notes 32-34 and accompanying text. A preliminary issue is whether the Code governs the liquidation or reorganization of the bankrupt entity. This Note presumes the applicability of the Code.

12. See *Bankruptcy Reform Hearing*, *supra* note 3, at 341 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n) (capital tied up); Letter from Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, to Hon. Robert J. Dole, Chairman, Subcomm. on Courts of the Senate Comm. on the Judiciary (Jan. 20, 1983) (risk of capital loss) [hereinafter cited as Volcker Letter I], reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305; *Senate Hearing*, *supra* note 1, at 1 (remarks of Sen. D'Amato, Subcomm. Chairman) (counterparties could have failed); *id.* at 25 (statement of Anthony Solomon, President, Fed. Reserve Bank of N.Y.) (capital tied up); Rosenthal Letter, *supra* note 3, at 4 (loss of interest and principal); Letter from Paul A. Volcker, Chairman, Board of Governors of the Federal Reserve System, to Hon. Peter W. Rodino, Jr., Chairman, House Comm. on the Judiciary 2 (Jan. 20, 1983) (risk of capital loss) [hereinafter cited as Volcker Letter II]. Prior to the *Lombard-Wall* ruling, which did not permit liquidation of the securities, market participants had assumed they could liquidate securities immediately on default. M. Stigum, *supra* note 2, at 421; see Volcker Letter I, *supra*, reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305; Supplemental Memorandum of the Investment Company Institute as *Amicus Curiae* at 5, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Oct. 8, 1982) [hereinafter cited as ICI Supplemental Memorandum]. The *Lombard-Wall* ruling transformed this view of repos as essentially riskless transactions. See M. Stigum, *supra* note 2, at 421. The risk in the transaction now depends not only on the quality of the underlying securities but also on the creditworthiness of the counterparty. See Letter from W. Dennis Thomas, Ass't Sec'y (Legislative Affairs), Dep't of the Treasury, to Rep. Benjamin S. Rosenthal, Chairman, Subcomm. on Commerce,

The repo market plays an important role in the nation's economy. The Federal Reserve uses repos to implement monetary policy.¹⁴ Government securities dealers finance their portfolios with repos.¹⁵ Mutual funds, state and local governments, corporations, and other institutions find repos an attractive investment for idle cash balances.¹⁶ Thus, the flexibility of repos as to duration and amount serves the liquidity needs of a broad array of market participants.¹⁷ Because the underlying securities in a repo are typically of high quality, repos used to be considered virtually risk-free.¹⁸ The *Lombard-Wall* ruling introduced uncertainty about the Code's treatment of repos that makes risk management by market participants more difficult and contributes to a contraction of the repo market.¹⁹

Part I of this Note explores the ramifications under the Code of the alternative characterizations of a repo. Part II discusses the elements of a repurchase agreement, the function and structure of the repurchase market, and the character of the transaction. This Part concludes that under the Code a repurchase agreement is likely to be treated as a secured loan. Part III examines proposed legislation that would limit the impact of the Code's automatic stay provision, and supports the legislation with minor modification.

Consumer, and Monetary Affairs of the House Comm. on Governmental Operations 1 (June 4, 1982). Predictably, the repo rate has risen to account for this added risk. *Bankruptcy Reform Hearing*, *supra* note 3, at 306 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.). Moreover, there has been a reluctance to enter into transactions with smaller dealers, thus removing some of them from the market. This reduces liquidity in the market. See PSA Survey, *supra* note 2, at 6.

13. Volcker Letter I, *supra* note 12, reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305; *Senate Hearing*, *supra* note 1, at 1 (statement of Sen. D'Amato, Subcomm. Chairman); *id.* at 36 (statement of Anthony Solomon, President, Fed. Reserve Bank of N.Y.); Russo Letter, *supra* note 3, at 1; see *Bankruptcy Reform Hearing*, *supra* note 3, at 341 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); Welles, *supra* note 1, at 74.

14. See *infra* notes 89-91 and accompanying text.

15. See *infra* notes 94-97 and accompanying text.

16. See *infra* notes 100-03 and accompanying text.

17. See *infra* note 88 and accompanying text.

18. M. Stigum, *supra* note 2, at 421; see Volcker Letter I, *supra* note 12, reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305.

19. See *Bankruptcy Reform Hearing*, *supra* note 3, at 306 (testimony of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.). The unsettled state of the law has also made it difficult for market participants to negotiate written repurchase agreements. PSA Survey, *supra* note 2, at 7; *Survey of Repo Market Shows Major Structural Changes and Widespread Problems Caused by Delay in Bankruptcy Law Changes* (Draft News Release prepared by Public Securities Ass'n Jan. 26, 1984) [hereinafter cited as PSA Release]. See *infra* note 121 and accompanying text.

I. BANKRUPTCY CODE CONSEQUENCES

Either party in a repo might go bankrupt. The consequences for the counterparty will vary according to how a repo is characterized. The consequences also depend on whether the counterparty is the buyer-lender, who has originally supplied funds for the securities, or the seller-borrower, who has exchanged his securities for the funds.

If a repo is characterized as a sale, the agreement to repurchase the security is an executory contract because performance remains due on both sides.²⁰ The trustee-in-bankruptcy generally may assume or reject any executory contract.²¹ To assume the repo, the trustee would first have to cure any default by tendering either the securities or the repurchase price, depending on whether the bankrupt was the buyer-lender or the seller-borrower.²² The counterparty is nonetheless presented with a number of practical problems. If the trustee rejects the contract, the estate remains liable for contract damages,²³ but the claim for the difference between the repurchase price and the market value of the securities is unsecured and might prove worthless.²⁴ Moreover, the trustee's ability to delay before deciding whether to assume or reject the contract²⁵ allows the trustee to speculate at the counterparty's risk. For example, if the bankrupt is the seller-borrower, the trustee will reject the contract to repurchase if the market price of the securities falls below the repurchase price. If the bankrupt is the

20. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 347 (1977) [hereinafter cited as 1977 House Report], reprinted in 1978 U.S. Code Cong. & Ad. News 5963, 6303; N.Y. State Bar Ass'n, Proceedings of the Banking, Corporation and Business Law Section 35 (Apr. 1983) [hereinafter cited as Bar Proceedings]; Bankruptcy Implications, *supra* note 3, at 15. Even under a secured-loan characterization, there is arguably an executory contract because the lender must return the collateral in exchange for cash. See *id.* at 15. It appears, however, that secured loans are not to be treated as executory contracts. See *In re Sparago*, 31 Bankr. 552, 554 (Bankr. E.D.N.Y. 1983) (secured car loan not executory contract); *In re Whitley*, 16 Bankr. 394, 397-98 (Bankr. N.D. Ohio 1982) (same).

21. 11 U.S.C. § 365(a) (1982); Bankruptcy Implications, *supra* note 3, at 15.

22. 11 U.S.C. § 365(b)(1) (1982); Bankruptcy Implications, *supra* note 3, at 15-16. One could argue that the importance of timely performance for repo transactions makes default incurable. See ICI Supplemental Memorandum, *supra* note 12, at 13.

23. 11 U.S.C. § 365(g)(2) (1982); Bar Proceedings, *supra* note 20, at 35. The counterparty has a claim for breach of contract at the time of commencement of the case. 11 U.S.C. § 365(g)(2) (1982). The case commences on the filing of the petition for bankruptcy. *Id.* §§ 301-304.

24. See J. White & R. Summers, Handbook of the Law under the Uniform Commercial Code 993 (2d ed. 1980); Bankruptcy Implications, *supra* note 3, at 27.

25. Bar Proceedings, *supra* note 20, at 35; see 11 U.S.C. § 365(d) (1982). In a reorganization, the trustee has until the confirmation of the plan of reorganization, but the counterparty may request the court to order an assumption or rejection within a specified time period. *Id.* § 365(d)(2).

buyer-lender, the trustee will resell the securities only if the repurchase price exceeds the market price.²⁶ The delay also destroys the short-term nature of the transaction and undermines the market's ability to provide a low-risk mechanism for cash management.²⁷

The primary advantage to the market of a sale characterization is that the buyer-lender may liquidate the securities in the event of default by the seller-borrower. The trustee merely has a contract right to purchase securities at a given price.²⁸ Because this right is not an interest in the securities,²⁹ the securities are not property of the estate, and therefore, are not covered by the automatic stay provision.³⁰

If a repo is characterized as a secured loan, however, the securities are collateral and may not be liquidated by the buyer-lender. The seller-borrower's interest in the securities would be property of the estate.³¹ The automatic stay provision precludes any act to create,

26. See ICI Supplemental Memorandum, *supra* note 12, at 13-14; cf. Russo Letter, *supra* note 3, at 2 (delay allows taking advantage of post-petition interest rules).

27. See ICI Supplemental Memorandum, *supra* note 12, at 5 ("The ability to redeem promptly, at net asset value, is crucial to the operation of [mutual] funds and the maintenance of investor confidence."); Russo Letter, *supra* note 3, at 2 ("[D]elay . . . may be catastrophic in an industry whose participants depend on the ability to continue rolling over obligations."). Applying the executory-contract provision would nonetheless be more favorable to the market than a loan characterization, because the assumption or rejection of a contract is generally more expeditious than the lifting of the automatic stay which requires the party seeking to lift the stay to show cause. Compare 11 U.S.C. § 365(d)(2) (1982) (no need to show cause to force trustee to assume or reject contract within specified time) with *id.* § 362(d)(1) (must show cause to lift automatic stay); see *In re Anderson*, No. 83-0073 (Bankr. D. Hawaii July 11, 1983) (available on LEXIS, Genfed library, Bkrcty file) (automatic stay not lifted but executory contract ordered assumed or rejected promptly).

28. Memorandum of the Investment Company Institute as *Amicus Curiae* in Opposition to the Plaintiff's Application for a Preliminary Injunction at 13-14, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Aug. 30, 1982) [hereinafter cited as ICI Memorandum]; *Amicus* Brief submitted on behalf of Goldman, Sachs & Co. and Salomon Brothers, Inc. in Opposition to the Debtor's Application for Injunctive Relief at 17, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Aug. 22, 1982) [hereinafter cited as Goldman Brief].

29. If the original transfer of securities is a sale, the seller-borrower has given up all ownership rights. ICI Memorandum, *supra* note 28, at 12-14. Of course, the contract right itself is intangible property of the estate. *In re Plunkett*, 23 Bankr. 392, 394 (Bankr. E.D. Wis. 1982); *In re Adana Mortgage Bankers*, 12 Bankr. 989, 1004 (Bankr. N.D. Ga. 1980); ICI Memorandum, *supra* note 28, at 14.

30. Goldman Brief, *supra* note 28, at 17. The buyer-lender may liquidate the securities if they are not property of the estate. See 11 U.S.C. § 362(a)(4) (1982). Property of the estate includes all property in which the debtor had any legal or equitable interest. *Id.* § 541(a)(1).

31. Plaintiff's Memorandum of Law in Support of its Application for Injunctive Relief at 2, *In re Lombard-Wall*, No. 82-B-11556 (Bankr. S.D.N.Y. Aug. 16, 1982); see Bar Proceedings, *supra* note 20, at 33. Even if legal title passes in a repo, the seller-borrower retains an equitable interest in the securities. The situation is analo-

perfect or enforce any secured claim against property of the estate.³² Thus, the buyer-lender cannot liquidate the securities, despite the seller-borrower's default. The buyer-lender may have the right to have the stay lifted if the value of his collateral falls below the amount of his secured claim³³ or he is threatened with irreparable harm.³⁴ Such relief, however, is uncertain and might not be obtained quickly enough to protect the creditor from loss of principal and interest.³⁵ The automatic stay, on the other hand, would not affect a bankrupt buyer-lender's counterparty, who would have free use of the funds obtained through the repo.

The Code's "strong-arm" provision provides further protection to the estate by giving the trustee the rights of a judicial lien creditor.³⁶ These rights will defeat the buyer-lender's security interest if it is unperfected before the filing for bankruptcy,³⁷ leaving the buyer-lender with a mere unsecured claim for the repurchase price.³⁸ Market participants should follow appropriate procedures to perfect their security interests to protect themselves against this consequence of a secured loan characterization.³⁹

gous to an equitable mortgage where the borrower gives the lender a deed absolute in form as security for the loan. Equity treats such a transaction as a mortgage and not a sale. *Warner v. Gosnell*, 8 Ill. 2d 24, 30-31, 132 N.E.2d 526, 529 (1956). The intention of the parties determines the character of the transaction. *Id.*; *Fry v. D.H. Overmyer Co.*, 269 Or. 281, 292-93; 525 P.2d 140, 145-46 (1974). This note argues that the intent of the parties is most accurately inferred from the economic substance of the transaction which is a secured loan. See *infra* notes 54-80 and accompanying text.

32. *Richlands Nat'l Bank v. Smith*, 34 Bankr. 749, 753 (Bankr. W.D. Va. 1983); 11 U.S.C. § 362(a)(4) (1982); see *Bankruptcy Implications*, *supra* note 3, at 20-21.

33. *Standard Fed. Sav. & Loan Ass'n v. Phelps (In re Chatman)*, 23 Bankr. 176, 178 (Bankr. N.D. Ill. 1982); 11 U.S.C. § 362(d) (1982); *Bankruptcy Implications*, *supra* note 3, at 21-22.

34. *General Elec. Credit v. Montgomery Mall Ltd. Partnership*, 704 F.2d 1173, 1176 (10th Cir.), *cert. denied*, 104 S. Ct. 108 (1983); 11 U.S.C. § 362(f) (1982).

35. See H.R. Rep. No. 420, 97th Cong., 2d Sess. 2 [hereinafter cited as 1982 House Report], reprinted in 1982 U.S. Code Cong. & Ad. News 583, 584; M. Stigum, *supra* note 2, at 421-22; cf. Letter from Thomas A. Russo, Esq. to Rep. Benjamin S. Rosenthal, Chairman, Commerce, Consumer and Monetary Affairs Subcomm. of the House Comm. on Gov't Operations 4 (July 20, 1982) (relief uncertain and would entail substantial delay) (available in files of *Fordham Law Review*). But cf. *Bankruptcy Implications*, *supra* note 3, at 11 ("Bankruptcy courts usually act reasonably promptly . . .").

36. See 11 U.S.C. § 544(a)(1) (1982); *Bankruptcy Implications*, *supra* note 3, at 19.

37. *J. White & R. Summers*, *supra* note 24, at 998; see 11 U.S.C. § 544(a)(1) (1982); U.C.C. § 9-301(b) (1977).

38. R. Hensen, *Handbook on Secured Transactions Under the Uniform Commercial Code* 259 (2d ed. 1979).

39. See *Bankruptcy Implications*, *supra* note 3, at 23; *Hirschberg*, *supra* note 5, at 220-21.

The trustee also has the power to avoid preferential loan repayments made up to ninety days prior to the filing for bankruptcy while the debtor was insolvent.⁴⁰ One example of a preference is when creditors take unusual action to enforce an unsecured claim or an unperfected secured claim shortly prior to a filing in bankruptcy.⁴¹ Thus, the following transfers may be avoidable as preferences: 1) subsequent transfers of additional collateral;⁴² 2) repurchase of the security, to the extent the repurchase price exceeds the market value at the time of repurchase;⁴³ and 3) repurchase of the security, when the buyer-lender's security interest is unperfected at the time of repurchase.⁴⁴ Such transfers are typical of repo transactions.⁴⁵ Because the transfers are made in the ordinary course of business, however, they are excepted from avoidance as preferences.⁴⁶

Under a sale characterization, repos are governed by the executory contracts provision, and the bankrupt's counterparties are at risk only to the extent they are either oversecured seller-borrowers or undersecured buyer-lenders. A loan characterization also subjects a buyer-lender to the risks of the application of the automatic stay, "strong-arm," and preferences provisions. Determination of the proper characterization accordingly is helpful to clarify the risk exposure of repo participants.

40. 11 U.S.C. § 547(b) (1982); *see, e.g., In re Vance*, 721 F.2d 259, 260 & n.1 (9th Cir. 1983); *Consove v. Cohen (In re Roco Corp.)*, 701 F.2d 978, 985 & n.12 (1st Cir. 1983); *Barash v. Public Fin. Corp.*, 658 F.2d 504, 507 (7th Cir. 1981). *But see* 11 U.S.C. § 547(c) (1982) (exceptions to the general rule).

41. *See In re Iowa Premium Serv. Co.*, 676 F.2d 1220, 1222-23 (Gibson, J., dissenting), *rev'd en banc on other grounds*, 695 F.2d 1109 (8th Cir. 1982); *Barash v. Public Fin. Corp.*, 658 F.2d 504, 510 (7th Cir. 1981); S. Rep. No. 989, 95th Cong., 2d Sess. 88 [hereinafter cited as 1978 Senate Report], *reprinted in* 1978 U.S. Code Cong. & Ad. News 5787, 5874; 1977 House Report, *supra* note 20, at 373, *reprinted in* 1978 U.S. Code Cong. & Ad. News at 6329.

42. *See Bankruptcy Implications, supra* note 3, at 32; Letter from Wachtell, Lipton, Rosen & Katz to its Clients 3 (May 26, 1982) (available in files of *Fordham Law Review*) [hereinafter cited as Wachtell Letter].

43. *See Bankruptcy Implications, supra* note 3, at 30.

44. Payment of an unsecured loan is a preference unless it falls within one of the exceptions to 11 U.S.C. § 547 (1982). *See In re Brent Exploration Co.*, 31 Bankr. 745, 752 (Bankr. D. Col. 1983).

45. *See Bar Proceedings, supra* note 20, at 23, 44. *See infra* notes 58, 67 and accompanying text.

46. 11 U.S.C. § 547(c)(2) (1982); *see In re Iowa Premium Serv. Co.*, 676 F.2d 1220, 1221, *rev'd en banc on other grounds*, 695 F.2d 1109 (8th Cir. 1982); *Barash v. Public Fin. Corp.*, 658 F.2d 504, 510 (7th Cir. 1981); *Bankruptcy Implications, supra* note 3, at 18, 31. The repayment must be within forty-five days after the debt was incurred. 11 U.S.C. § 547(c)(2)(B) (1982). This requirement will usually not affect repos, which are of very short duration. *See infra* note 87 and accompanying text.

II. CHARACTERIZING THE TRANSACTION

Several factors are relevant to the characterization of a repurchase agreement. The economic substance of a repo and the form of the agreement provide the most insight into the true nature of the transaction. Bankruptcy policy and the impact on the securities markets must also be considered.

A. *Economic Substance and the Parties' Intent*

In characterizing a repo transaction, courts consider whether the parties intended to effect a sale or a secured loan.⁴⁷ Repos are typically oral agreements⁴⁸ with mixed terminology. The securities are called "collateral"⁴⁹ and the parties negotiate in terms of interest rates,⁵⁰ suggesting that a repo is a loan. The written confirmations of these oral agreements, however, characterize a repo as a sale.⁵¹ In order to provide greater certainty in the treatment of repos, repo participants have begun to utilize written "master" repurchase agreements to govern all transactions between the parties.⁵² These master repurchase agreements typically state that the parties intend the repo to be a sale.⁵³ This sale characterization may be self-serving, however, con-

47. See *First Nat'l Bank v. Estate of Russell*, 657 F.2d 668, 670 (5th Cir. 1981); *Walters v. Occidental Petroleum Corp. (In re Financial Corp.)*, 1 Bankr. 522, 526 n.7 (W.D. Mo. 1979), *aff'd per curiam*, 634 F.2d 404 (8th Cir. 1980). In *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 117 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970), however, subjective intent was held not to be decisive for tax purposes.

48. Bankruptcy Implications, *supra* note 3, at 4; e.g., *Walters v. Occidental Petroleum Corp. (In re Financial Corp.)*, 634 F.2d 404, 404 (8th Cir. 1980) (*per curiam*); *American Nat'l Bank v. United States*, 421 F.2d 442, 450 (5th Cir.) (telephonic negotiations), *cert. denied*, 400 U.S. 819 (1970); *Cosmopolitan Credit & Inv. Corp. v. Blyth Eastman Dillon & Co.*, 507 F. Supp. 954, 956 (S.D. Fla. 1981) (same).

49. *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); Affidavit in Support of Motion to Vacate at 2, *In re Lombard-Wall, Inc.*, No. 82-B-11556 (Bankr. S.D.N.Y. Sept. 3, 1982) [hereinafter cited as *Kurtz Affidavit*]; *M. Stigum*, *supra* note 2, at 398-99.

50. *SEC v. Miller*, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); *M. Stigum*, *supra* note 2, at 399; see *Kurtz Affidavit*, *supra* note 49, at 2.

51. See Bankruptcy Implications, *supra* note 3, at 4, 20; Goldman Brief, *supra* note 28, at 3; see Wachtell Letter, *supra* note 42, at 1. The parties' internal documentation also provides some indication of intent. See *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 117 & n.2 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980); Welles, *supra* note 1, at 78.

52. See *M. Stigum*, *supra* note 2, at 398, 422; *Hirschberg*, *supra* note 5, at 239-41; *PSA Survey*, *supra* note 2, at 4.

53. See *Salomon Brothers, General Repurchase Agreement 1-2* (1983) (available in files of *Fordham Law Review*). It has been recommended that master agreements

sidering the harsh impact of a loan characterization.⁵⁴ The parties to the transaction are sophisticated investors,⁵⁵ and their intent may be more accurately discerned from the economic substance of the transaction.⁵⁶

The economic substance of the typical repurchase agreement strongly supports a secured-loan characterization.⁵⁷ The seller retains many attributes of ownership and most terms of the agreement are more typical of a secured loan than a sale. For example, exposure to the risk of price fluctuations is a strong indicium of ownership that remains with the seller.⁵⁸ The seller's obligation to repurchase the

should contain a clause providing that if the repo be considered a secured loan, the parties intend to effect a security interest. See Dunning, *Drafting Repurchase and Reverse Repurchase Agreements*, in Practising Law Institute, *Repurchase and Reverse Repurchase Agreements* 183, 188 (1982) (Course Handbook Series No. 290).

54. See Dauphin Memorandum, *supra* note 3, at 3-5 (evading restriction on loans); PSA Survey, *supra* note 2, at 17; *cf.* First American Nat'l Bank v. United States, 467 F.2d 1098, 1101 (6th Cir. 1972) (per curiam) (sale characterization to avoid tax); Union Planters Nat'l Bank v. United States, 426 F.2d 115, 116, 118 (6th Cir.) (same), *cert. denied*, 400 U.S. 827 (1970); American Nat'l Bank v. United States, 421 F.2d 442, 451-52 (5th Cir.) (same), *cert. denied*, 400 U.S. 819 (1970); SEC v. Miller, 495 F. Supp. 465, 467 (S.D.N.Y. 1980) (circumventing regulation).

55. Repo market participants are typically large financial institutions and governmental authorities. *Bankruptcy Reform Hearing*, *supra* note 3, at 330 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); *id.* at 340 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); Volcker Letter II, *supra* note 12, at 1.

56. See American Nat'l Bank v. United States, 421 F.2d 442, 451-52 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970); Union Planters Nat'l Bank v. United States, 426 F.2d 115, 118 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970).

57. Report of the Division of Investment Management of the Securities and Exchange Comm. Concerning Advertising and Promotional Practices of Money Market Funds Investing in Securities Issued by United States Government Sponsored Agencies and the Purchase of Repurchase Agreements Collateralized by such Securities 6 (1982); M. Stigum, *supra* note 2, at 417; see United States v. Erickson, 601 F.2d 296, 300 n.4 (7th Cir.) (repo is secured loan for tax purposes), *cert. denied*, 444 U.S. 979 (1979); First Am. Nat'l Bank v. United States, 467 F.2d 1098, 1101 (6th Cir. 1972) (per curiam) (same); Union Planters Nat'l Bank v. United States, 426 F.2d 115, 118 (6th Cir.) (same), *cert. denied*, 400 U.S. 827 (1970). *But see* Gilmore v. State Bd. of Admin., 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980). Even if a repo is economically a secured loan, a repo may still be a purchase and sale of securities within the meaning of the federal securities laws, Extract of Minutes, at 41, Chase Manhattan Bank, N.A. v. Drysdale Securities Corp., No. 82-6621 (S.D.N.Y. Mar. 23, 1984); see First Nat'l Bank v. Estate of Russell, 657 F.2d 668, 676 n.24 (5th Cir. 1981), because even the transfer of a security interest may constitute a sale for purposes of the federal securities laws, see Rubin v. United States, 449 U.S. 424, 431 (1981). Whether a repo is itself a security is beyond the scope of this Note.

58. Hinkle Northwest, Inc. v. SEC, 641 F.2d 1304, 1307 (9th Cir. 1981); First Am. Nat'l Bank v. United States, 467 F.2d 1098, 1101 (6th Cir. 1972) (per curiam); Union Planters Nat'l Bank v. United States, 426 F.2d 115, 118 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970).

securities at a specified price insulates the buyer from any risk of market fluctuations.⁵⁹

The price structure of the transaction further supports a loan characterization. Ordinarily, in a sale of securities, the price is the fair market value.⁶⁰ In a repurchase agreement, however, the market value of the securities generally exceeds the purchase price.⁶¹ This discrepancy between the market price of the securities and the amount of money initially transferred is typical of a secured loan.⁶² The excess value, or margin, serves as a cushion against adverse market shifts should the buyer-lender need to liquidate the security in the event of default.⁶³ The determination of the repurchase price also supports a loan characterization. The price of securities to be pur-

The allocation of risk has been the most important factor for determining the characterization of a repo for purposes of the Internal Revenue Code. The tax issue arises when the underlying security is a municipal bond. *First Am. Nat'l Bank v. United States*, 467 F.2d 1098, 1100 (6th Cir. 1972) (per curiam). If the buyer-lender owns the bond, the interest is excluded from income under I.R.C. § 103 (1976). 467 F.2d at 1099-100. If the seller-borrower owns the bond, the coupon payments are simply interest on a loan which is includible in gross income. *Id.* at 1101. These interest payments are not deductible under I.R.C. § 265 because the loan is used to carry a tax-exempt investment. The circuit courts addressing this issue have unanimously treated repos as loans for tax purposes, concluding that they are attempts to circumvent § 265. *Id.* The courts considered risk allocation the critical element for determining the economic substance of the transaction. *Id.* at 1102.

59. *First Am. Nat'l Bank v. United States*, 467 F.2d 1098, 1101 (6th Cir. 1972) (per curiam); *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 118 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); R. Edmister, *Financial Institutions* 442 (1980); *see First Nat'l Bank v. Estate of Russell*, 657 F.2d 668, 675 (5th Cir. 1981) (gain or loss accrues to seller-borrower). If the original seller had an option rather than an obligation to repurchase the securities, each party would be exposed to significant risk and a sale characterization might be appropriate. In *American Nat'l Bank v. United States*, 421 F.2d 442 (5th Cir.), *cert. denied*, 400 U.S. 819 (1970), the seller-borrower's exercise of the options regardless of market conditions, *id.* at 450, led the court to conclude that there was no reallocation of risk, *id.* at 453. Such an option, it has been pointed out, would likely make a repo an unattractive investment vehicle because it would significantly increase its risk. *See Walters v. Occidental Petroleum Corp. (In re Financial Corp.)*, 1 Bankr. 522, 526 (Bankr. W.D. Mo. 1979), *aff'd per curiam*, 634 F.2d 404 (8th Cir. 1980).

60. W. Sharpe, *supra* note 1, at 23; M. Stigum, *supra* note 2, at 421.

61. M. Stigum, *supra* note 2, at 400; *see, e.g., First Nat'l Bank v. Estate of Russell*, 657 F.2d 668, 675 (5th Cir. 1981); *SEC v. Miller*, 495 F. Supp. 465, 469-70 (S.D.N.Y. 1980); *Union Planters Nat'l Bank v. United States*, 295 F. Supp. 1151, 1152 (W.D. Tenn. 1968), *rev'd on other grounds*, 426 F.2d 115 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970).

62. *SEC v. Miller*, 495 F. Supp. 465, 469 (S.D.N.Y. 1980); M. Stigum, *supra* note 2, at 421.

63. ICI Memorandum, *supra* note 28, at 6-8; *see SEC v. Miller*, 495 F. Supp. 465, 469-70 (S.D.N.Y. 1980); *Senate Hearing, supra* note 1, at 4 (testimony of Mark Stalneck, Deputy Ass't Sec'y for Fed. Fin., Dep't of the Treasury).

chased at a future date is ordinarily based on expectations regarding future market price,⁶⁴ whereas in a repo, the repurchase price is based on the initial sale price.⁶⁵ In fact, the most hotly-negotiated term in a repo is neither the purchase price nor the repurchase price, but rather the spread between the two.⁶⁶ This spread is invariably calculated in terms of interest rates.⁶⁷ The pricing framework thus implies that a repo is a loan and not a sale.

Repurchase agreements also typically contain a "mark-to-market" provision⁶⁸ requiring the seller to transfer additional securities if the market value of the original securities declines below a specified amount.⁶⁹ This provision further insulates the buyer from the risk of default. Such a margining practice is characteristic of a secured loan, but inconsistent with a sale.⁷⁰

The right to interest on a security is another indication of ownership.⁷¹ In a repo, the seller-borrower usually retains the right to the interest that accrues on the security during the period of the repo.⁷²

64. W. Sharpe, *supra* note 1, at 417; see E. Elton & M. Gruber, *Modern Portfolio Theory and Investment Analysis* 442 (1981).

65. M. Stigum, *supra* note 2, at 399; see S. Goldfeld & L. Chandler, *supra* note 7, at 462; L. Ritter & W. Silber, *supra* note 7, at 118 n.1.

66. See SEC v. Miller, 495 F. Supp. 465, 467 (S.D.N.Y. 1980).

67. *Id.*; see *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980); L. Ritter & W. Silber, *supra* note 7, at 118 n.1; M. Stigum, *supra* note 2, at 399; Bankruptcy Implications, *supra* note 3, at 3. The overnight repo rate tends to track the federal funds rate, see M. Stigum, *supra* note 2, at 407, suggesting that the spread represents the time value of money, see *id.* at 396. Federal funds are unsecured interbank loans of reserves. See *id.* at 407. Due to the secured nature of a repo, the rate on repos is usually slightly below the federal funds rate. *Id.* Since the *Lombard-Wall* decision, however, this spread has narrowed. *Bankruptcy Reform Hearing*, *supra* note 3, at 313 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); PSA Release, *supra* note 19, at 1.

68. SEC v. Miller, 495 F. Supp. 465, 470 (S.D.N.Y. 1980); see Dunning, *supra* note 53, at 190.

69. SEC v. Miller, 495 F. Supp. 465, 470 (S.D.N.Y. 1980); see *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 117 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); Bankruptcy Implications, *supra* note 3, at 3.

70. *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 117 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); M. Stigum, *supra* note 2, at 421; see Novikoff & Julis, *Repurchase and Reverse Repurchase Agreements under Articles 8 & 9 of the Uniform Commercial Code*, in *Practising Law Institute, Repurchase and Reverse Repurchase Agreements* 79, 89 (1982) (Course Handbook Series No. 290).

71. M. Stigum, *supra* note 2, at 421 (buyer of security receives interest payment); see also *Energy Oils, Inc. v. Montana Power Co.*, 626 F.2d 731, 736 (9th Cir. 1980) (ownership includes right to enjoy property).

72. *Cosmopolitan Credit & Inv. Corp. v. Blyth Eastman Dillon & Co.*, 507 F. Supp. 954, 956 (S.D. Fla. 1981); SEC v. Miller, 495 F. Supp. 465, 467 (S.D.N.Y. 1980); *Senate Hearing*, *supra* note 1, at 6 (testimony of Mark Stalneck, Deputy Ass't Sec'y for Fed. Fin., Dep't of the Treasury); Bankruptcy Implications, *supra* note

The retention of this right suggests that a repo is not a sale. Moreover, in the event of default by the seller-borrower, the buyer-lender has the right to liquidate the security. The buyer-lender, however, ordinarily must forward any excess of the liquidation price over the repurchase price to the seller-borrower.⁷³ Such a transfer of sale proceeds is hardly consistent with the characterization of the buyer-lender as owner of the securities. Rather, this disposition of sale proceeds is typical of a secured transaction with the holder of collateral seeking to satisfy a secured claim.⁷⁴

Although these typical repo provisions indicate that the economic impact of the transaction is that of a secured loan, two limited ownership rights pass to the buyer-lender, suggesting that a repo might be a sale. In a typical collateralized loan, the lender has only a limited right to use,⁷⁵ and no right to sell the collateral.⁷⁶ In a repo, however, the buyer-lender ordinarily has the right to repledge or resell the securities.⁷⁷

The buyer-lender's right to sell the securities unencumbered by any rights of the seller-borrower is a powerful indicium of ownership.⁷⁸ This right, however, is subject to an obligation to substitute comparable securities of equal market value.⁷⁹ The ability to substitute suggests

3, at 20. Even where the buyer-lender receives the coupons, they are considered interest on a loan. *First Am. Nat'l Bank v. United States*, 467 F.2d 1098, 1100-01 (6th Cir. 1972) (per curiam); *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 116 (6th Cir.), cert. denied, 400 U.S. 827 (1970); *American Nat'l Bank v. United States*, 421 F.2d 442, 452-53 (5th Cir.), cert. denied, 400 U.S. 819 (1970).

73. See M. Stigum, *supra* note 2, at 422; Kurtz Affidavit, *supra* note 49, at 3; Bar Proceedings, *supra* note 20, at 35. But see *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 117 n.3 (6th Cir.) (buyer kept excess), cert. denied, 400 U.S. 827 (1970); *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980) (same).

74. See *Major's Furniture Mart, Inc. v. Castle Credit Corp.*, 449 F. Supp. 538, 541 (E.D. Pa. 1978), *aff'd*, 602 F.2d 538 (3d Cir. 1979); *Dopp v. Franklin Nat'l Bank*, 374 F. Supp. 904, 910 (S.D.N.Y. 1974); U.C.C. § 9-504(2) (1977).

75. U.C.C. § 9-207(4) (1977).

76. See *Novikoff & Julis*, *supra* note 70, at 87-88. The secured party may dispose of the collateral in a commercially reasonable manner following default. U.C.C. § 9-504 (1977).

77. *SEC v. Miller*, 495 F. Supp. 465, 469 (S.D.N.Y. 1980); *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980); *Bankruptcy Implications*, *supra* note 3, at 3; Letter from Theodore Gewertz, Esq. to Hon. Edward Ryan 2 (Sept. 21, 1982) (available in files of *Fordham Law Review*). The repo in *Lombard-Wall* did not give the buyer-lender the right to resell and repledge the securities, arguably limiting the scope of the *Lombard-Wall* holding. *Id.*

78. See *Hinkle Northwest v. SEC*, 641 F.2d 1304, 1307 (9th Cir. 1981); *Energy Oils, Inc. v. Montana Power Co.*, 626 F.2d 731, 735-36 (9th Cir. 1980); 6 *American Law of Property* § 26.1 (A. Casner ed. 1952).

79. *SEC v. Miller*, 495 F. Supp. 465, 469 (S.D.N.Y. 1980); *Gilmore v. State Bd. of Admin.*, 382 So. 2d 861, 863 (Fla. Dist. Ct. App. 1980); *Bankruptcy Implications*, *supra* note 3, at 3.

that the seller-borrower does not have a continuing ownership interest in the property but merely a contract right to purchase similar securities.⁸⁰ The right to sell the collateral allows the buyer-lender to speculate in the securities market.⁸¹ This risk, however, is independent of the repo's market risk allocation, which remains with the seller-borrower,⁸² who must repurchase at a specified price regardless of market conditions.

The economic substance of the transaction thus strongly suggests that a repo is a secured loan, but a loan characterization has deleterious effects on the repurchase market. Because of the potential ramifications of the repo controversy on the financial markets, the clash between bankruptcy policy and economic policy must be examined.

B. Bankruptcy Policy versus Economic Policy

A tension exists between economic policy and bankruptcy policy. Bankruptcy policy favors the broadest application of the automatic stay provision and thus the characterization of repos as loans. Economic policy, on the other hand, favors a sale characterization, which would minimize the disruptive effect of a repo market participant's bankruptcy on the market.

The automatic stay is one of the Code's fundamental protections.⁸³ It should be applied broadly to give "breathing space" to the bankrupt, enabling it to reorganize. The stay prevents the estate from being torn apart in a disorderly "first-come, first-serve" liquidation.⁸⁴ Accordingly, bankruptcy policy favors a loan characterization be-

80. See ICI Memorandum, *supra* note 28, at 13.

81. See *SEC v. Miller*, 495 F. Supp. 465, 471-72 (S.D.N.Y. 1980). For example, the buyer-lender may resell the securities in the market hoping to require them at a lower price when he is required to sell them to the seller-borrower to fulfill the repo obligation. *Senate Hearing*, *supra* note 1, at 4 (statement of Mark Stalneck, Deputy Asst Sec'y for Fed. Fin., Dep't of the Treasury).

82. See *Union Planters Nat'l Bank v. United States*, 426 F.2d 115, 118 (6th Cir.), *cert. denied*, 400 U.S. 827 (1970); R. Edmister, *supra* note 59, at 442.

83. *In re Bialac*, 712 F.2d 426, 431 (9th Cir. 1983); *In re Pizza of Hawaii, Inc.*, 12 Bankr. 796, 798 (Bankr. D. Hawaii 1981); *In re Adana Mortgage Bankers, Inc.*, 12 Bankr. 989, 997 (Bankr. N.D. Ga. 1980); 1978 Senate Report, *supra* note 41, at 54, *reprinted in* 1978 U.S. Code Cong. & Ad. News at 5840; 1977 House Report, *supra* note 20, at 340, *reprinted in* 1978 U.S. Code Cong. & Ad. News at 6296-97.

84. *In re Bialac*, 712 F.2d 426, 431 (9th Cir. 1983); *Ellison v. Northwest Eng'g Co.*, 707 F.2d 1310, 1311 (11th Cir. 1983); *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544 (5th Cir. 1983); 1978 Senate Report, *supra* note 41, at 54-55, *reprinted in* 1978 U.S. Code Cong. & Ad. News at 5840-41; 1977 House Report, *supra* note 20, at 340, *reprinted in* 1978 U.S. Code Cong. & Ad. News at 6296-97; Bankruptcy Implications, *supra* note 3, at 12.

cause the securities would then be considered property of the estate and subject to the automatic stay.⁸⁵

The economic substance of the transaction and the Code's policy must be considered in light of the impact a loan characterization would have on the repurchase market. The repurchase market is large and complex⁸⁶ with daily transactions conservatively estimated at \$150 billion.⁸⁷ Repos are usually of very short duration.⁸⁸ Their low risk combined with their unique flexibility as to amount and maturity allow repos to serve the varying needs of a broad range of institutions.⁸⁹

The Federal Reserve uses repos as an important tool to implement monetary policy through manipulation of monetary reserves.⁹⁰ Repos allow very large, rapid interventions without the market disruption or risk that would accompany outright sales and purchases of government securities.⁹¹ Consequently, any contraction of the repurchase

85. See *Wedgeworth v. Fibreboard Corp.*, 706 F.2d 541, 544 (5th Cir. 1983); *In re Adams*, 27 Bankr. 582, 583 (Bankr. D. Del. 1983); 1978 Senate Report, *supra* note 41, at 49, reprinted in 1978 U.S. Code Cong. & Ad. News at 5835; 1977 House Report, *supra* note 20, at 340, reprinted in 1978 U.S. Code Cong. & Ad. News at 6296-97; Application for Order, *supra* note 9, at 2; J. White & R. Summers, *supra* note 24, at 993; Bankruptcy Implications, *supra* note 3, at 12.

86. *Bankruptcy Reform Hearing*, *supra* note 3, at 337-38 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n) ("the largest capital market in the world"); Welles, *supra* note 1, at 78 ("[T]he government market has become an almost infinitely complex circuitry of [repos] . . .").

87. M. Stigum, *supra* note 2, at 395; Welles, *supra* note 1, at 78.

88. See S. Goldfeld & L. Chandler, *supra* note 7, at 246; L. Ritter & W. Silber, *supra* note 7, at 118 n.1. Due to the liquidity risks currently associated with repos, the duration has shortened to reduce the likelihood of default. See PSA Survey, *supra* note 2, app. at 25, 31. The duration of repos is usually less than one week. S. Goldfeld & L. Chandler, *supra* note 7, at 246; L. Ritter & W. Silber, *supra* note 7, at 118 n.1; Volcker Letter II, *supra* note 12, at 1.

89. *Bankruptcy Reform Hearing*, *supra* note 3, at 339-40, 344 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); see *SEC v. Miller*, 495 F. Supp. 465, 471 (S.D.N.Y. 1980); *Bankruptcy Reform Hearing*, *supra* note 3, at 310 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); Volcker Letter II, *supra* note 12, at 1.

90. See *SEC v. Miller*, 495 F. Supp. 465, 470-71 (S.D.N.Y. 1980); *Bankruptcy Reform Hearing*, *supra* note 3, at 310 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); *id.* at 339 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Div. of the Pub. Sec. Ass'n); Volcker Letter I, *supra* note 12, reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305; L. Ritter & W. Silber, *supra* note 7, at 210-11; Bankruptcy Implications, *supra* note 3, at 4.

91. *Bankruptcy Reform Hearing*, *supra* note 3, at 310-11 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); see Letter from Rep. Walter E. Fauntroy, Chairman, Subcomm. on Domestic Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs to Hon. Peter W. Rodino,

market, due to fears of liquidity problems arising from the bankruptcy of a repo counterparty, would impair the Federal Reserve's ability to implement monetary policy.⁹² This deep and smoothly functioning market facilitates the Fed's ability to make investments on behalf of foreign central banks.⁹³ Moreover, an efficient repo market increases foreign demand for government securities and thus lowers the cost of financing the national debt.⁹⁴

Repurchase agreements also provide a major source of funding for government securities dealers.⁹⁵ The Treasury relies heavily on these dealers to absorb new government debt issues.⁹⁶ Any limitation on dealers' ability to obtain financing would increase the Treasury's cost of borrowing.⁹⁷ Any increase in the dealers' cost of financing would exert upward pressure on the interest rate bid by dealers on new

Jr., Chairman, House Comm. on the Judiciary 1 (June 29, 1983) (available in files of *Fordham Law Review*) [hereinafter cited as Fauntroy Letter].

92. See *Bankruptcy Reform Hearing*, *supra* note 3, at 311-12, 314 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); Volcker Letter I, *supra* note 12, reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305; Goldman Brief, *supra* note 28, at 7-8; cf. Fauntroy Letter, *supra* note 91, at 1 (broad-based participation necessary).

93. See *Bankruptcy Reform Hearing*, *supra* note 3, at 331 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.).

94. *Id.*; Memorandum of Law in Support of Federal Reserve's Motion to Intervene as *Amicus Curiae* and Brief as *Amicus Curiae* at 13-14, *In re Lombard-Wall, Inc.*, 82-B-11556 (Bankr. S.D.N.Y. Aug. 22, 1982) [hereinafter cited as Fed. Brief], reprinted in Practising Law Institute, *Repurchase and Reverse Repurchase Agreements* 320-21 (1982) (Course Handbook Series No. 290).

95. *Bankruptcy Reform Hearing*, *supra* note 3, at 311 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); M. Stigum, *supra* note 2, at 40-41; Welles, *supra* note 1, at 78; see SEC v. Miller, 495 F. Supp. 465, 471 (S.D.N.Y. 1980); *Bankruptcy Reform Hearing*, *supra* note 3, at 340 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); *Senate Hearing*, *supra* note 1, at 4 (testimony of Mark Stalneck, Deputy Ass't Sec'y for Fed. Fin., Dep't of the Treasury); Goldman Brief, *supra* note 28, at 2, 5; *Bankruptcy Implications*, *supra* note 3, at 4.

96. See SEC v. Miller, 495 F. Supp. 465, 473 (S.D.N.Y. 1980); *Bankruptcy Reform Hearing*, *supra* note 3, at 311-12 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); *Senate Hearing*, *supra* note 1, at 3 (testimony of Mark Stalneck, Deputy Ass't Sec'y for Fed. Fin., Dep't of the Treasury).

97. See *Bankruptcy Reform Hearing*, *supra* note 3, at 311-12 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); *id.* at 343-44 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); Letter from Roger W. Mehle, Ass't Sec'y (Domestic Fin.), Dep't of the Treasury, to Hon. Robert J. Dole Chairman, Subcomm. on Courts of the Senate Comm. on the Judiciary 1 (March 16, 1983) (available in files of *Fordham Law Review*) [hereinafter cited as Mehle Letter]; see also Fauntroy Letter, *supra* note 91, at 1-2 (repos crucial to the financing of the public debt).

issues.⁹⁸ Further, any reduction in the primary dealers' capacity to absorb new debt would compel the Treasury to deal with more buyers, thereby raising underwriting costs.⁹⁹ Given the burgeoning government deficits,¹⁰⁰ even a minor increase in financing costs would impose a substantial fiscal burden on the Treasury.

The repurchase market also provides institutions with an attractive opportunity to invest their cash balances on a day-to-day basis.¹⁰¹ Such investments direct short-term funds to their area of greatest need at a low cost, thereby improving the overall efficiency of the financial markets and the economy.¹⁰² Timely performance of the seller's obligation to repurchase is critical to these institutions,¹⁰³ which require the funds to meet other financial obligations. Thus, subjecting the securities to the automatic stay would discourage these institutions from investing in the repo market, thereby reducing the liquidity of the market.¹⁰⁴

Most ominously, if a major market participant fails, highly-leveraged dealer counterparts might also fail because the automatic stay might tie up so much capital that the dealers could not fulfill their other financial obligations.¹⁰⁵ Such "ripple" bankruptcies could lead to a market crash.¹⁰⁶ Prior failures have not led to such dire

98. See Goldman Brief, *supra* note 28, at 6.

99. See *Bankruptcy Reform Hearing*, *supra* note 3, at 517-18 (statement of Investment Company Institute); *id.* at 311-12 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); Goldman Brief, *supra* note 28, at 6.

100. See N.Y. Times, Aug. 22, 1983, at D1, col. 3; Wall St. J., Aug. 22, 1983, at 4, col. 1.

101. See SEC v. Miller, 495 F. Supp. 465, 471 (S.D.N.Y. 1980); *Bankruptcy Reform Hearing*, *supra* note 3, at 515 (statement of Investment Company Institute); *id.* at 340 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); S. Goldfeld & L. Chandler, *supra* note 7, at 463 & n.12; Bankruptcy Implications, *supra* note 3, at 4.

102. *Bankruptcy Reform Hearing*, *supra* note 3, at 339 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); see *id.* at 314-15 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); R. Edmister, *supra* note 59, at 442 (low cost).

103. ICI Supplemental Memorandum, *supra* note 12, at 5; see *Bankruptcy Reform Hearing*, *supra* note 3, at 515-17 (statement of Investment Company Institute); see also Bankruptcy Implications, *supra* note 3, at 5 (ability to liquidate securities part of repo's attraction).

104. See Fed. Brief, *supra* note 94, reprinted in Practising Law Institute, Repurchase and Reverse Repurchase Agreements 321 (1982) (Course Handbook Series No. 290); Goldman Brief, *supra* note 28, at 9; ICI Supplemental Memorandum, *supra* note 12, at 20.

105. See *Bankruptcy Reform Hearing*, *supra* note 3, at 341 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); Goldman Brief, *supra* note 28, at 9; Welles, *supra* note 1, at 73-74.

106. Goldman Brief, *supra* note 28, at 9; see *Bankruptcy Reform Hearing*, *supra* note 3, at 341 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency

consequences. In the Drysdale collapse, Chase Manhattan Bank reluctantly assumed Drysdale's repurchase obligations, thus stemming an incipient market panic.¹⁰⁷ Fortunately, the Lombard-Wall default occurred at the onset of a major bull market, which allowed time for an orderly reorganization.¹⁰⁸ The trustee was able to delay payment and retain adequate resources to satisfy repo counterparts.¹⁰⁹ In the future, however, adverse market movements may require prompt liquidation to avert financial catastrophe.¹¹⁰

Code policy and the economic substance of the transaction suggest that repos should be treated as loans. Thus, it is likely that bankruptcy courts will treat repos as secured loans, despite the possible impact of such a characterization on the repo market. The severe threat posed to the economy by the the automatic stay warrants ameliorative legislation exempting repo participants from the operation of the stay.¹¹¹

III. PROPOSED RELIEF

In 1982, Congress exempted securities contracts of stockbrokers and clearing agencies from the automatic stay and preferences provision.¹¹² Although Congress sought to protect the sensitive and volatile securities markets,¹¹³ the scope of these technical amendments is limited.¹¹⁴ Legislation has since been introduced to exempt repos in government securities, bankers' acceptances, or certificates of deposit

Sec. Div. of the Pub. Sec. Ass'n); *Senate Hearing*, *supra* note 1, at 1 (statement of Sen. D'Amato, Subcomm. Chairman); Welles, *supra* note 1, at 74.

107. *See Senate Hearing*, *supra* note 1, at 1 (statement of Sen. D'Amato, Subcomm. Chairman); *id.* at 25-28 (statement of Anthony Solomon, President, Fed. Reserve Bank of N.Y.); Welles, *supra* note 1, at 74; Wall St. J., May 20, 1982, at 4, col. 1. *But see Senate Hearing*, *supra* note 1, at 5-7 (testimony of Mark Stalneck, Deputy Ass't Sec'y for Fed. Fin., Dep't of the Treasury) (market would continue to function without payments by Chase).

108. Bar Proceedings, *supra* note 20, at 39, 41; Masters, *Good Lawyering and Good Luck Aid Company's Reorganization*, Legal Times of N.Y., Nov. 22, 1982, at 6, col. 1.

109. Bar Proceedings, *supra* note 20, at 39, 41; Masters, *supra* note 108, at 6, col. 1.

110. *See* 128 Cong. Rec. 8133 (daily ed. July 13, 1982) (statement of Sen. Dole); Russo Letter, *supra* note 3, at 2.

111. *See Bankruptcy Reform Hearing*, *supra* note 3, at 344 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); Fauntroy Letter, *supra* note 91, at 2; Volcker Letter II, *supra* note 12, at 2.

112. Bankruptcy Act Amendments, P.L. No. 97-222, 96 Stat. 236 (1982) (current version at 11 U.S.C.A. §§ 555-556 (West Supp. 1983)).

113. 1982 House Report, *supra* note 35, at 3, *reprinted in* 1982 U.S. Code Cong. & Ad. News at 585; 128 Cong. Rec. 8133 (daily ed. July 13, 1982) (statement of Sen. Dole); *see* Bankruptcy Implications, *supra* note 3, at 8.

114. *See* Bankruptcy Implications, *supra* note 3, at 8; Fauntroy Letter, *supra* note 91, at 1 (scope insufficient to protect market).

from the automatic stay and preferences provisions.¹¹⁵ The securities markets' volatility and repo dealers' high degree of leverage justify this legislation, because prompt liquidation is necessary to the orderly functioning of the market.

The proposed legislation would promote an efficient and stable repurchase market, thereby serving vital economic interests. Nonetheless, critics have advanced several arguments against the legislation. First, they claim that the magnitude of the threat to the market is overstated.¹¹⁶ The Drysdale incident, however, demonstrates the market's potential fragility. Drysdale defaulted on approximately \$300 million in interest payments.¹¹⁷ Had Chase Manhattan not satisfied Drysdale's obligations, widespread financial chaos could have erupted.¹¹⁸ Moreover, default of even a small dealer poses a substan-

115. PSA Survey, *supra* note 2, at 2-3; e.g., H.R. 3418, 98th Cong., 1st Sess., 129 Cong. Rec. E3185 (daily ed. June 27, 1983); 129 Cong. Rec. H2524-25 (daily ed. May 2, 1983) (introduction of Bankruptcy Code Amendments to assure continued use of repos); S. 1013, title V, F, 98th Cong., 1st Sess., 129 Cong. Rec. 373 (daily ed. Apr. 27, 1983). The proposed amendments passed the Senate. 129 Cong. Rec. 5364, 5388 (daily ed. Apr. 27, 1983). This legislation has received unanimous support from financial institutions. *Bankruptcy Reform Hearing*, *supra* note 3, at 307 (testimony of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Securities Div. of the Pub. Securities Ass'n); *see id.* at 518 (statement of Investment Company Institute); Fauntroy Letter, *supra* note 91, at 2; Volcker Letter I, *supra* note 12, reprinted in *Bankruptcy Reform Hearing*, *supra* note 3, at 305. The only opposition has come from the Treasury Department. *See* Mehle Letter, *supra* note 97, at 1. Passage has been delayed by an unrelated controversy regarding the structure of the bankruptcy courts. *See* Public Securities Ass'n Memorandum Regarding Proposed Repo Bankruptcy Amendments 2 (May 10, 1983); Fauntroy Letter, *supra* note 91, at 2. This delay has stymied efforts by government securities dealers to counteract the deleterious effects of the Drysdale and Lombard-Wall defaults. PSA Release, *supra* note 19, at 1. The continuing uncertainties about how repos will be treated has magnified the difficulties of negotiating written repurchase agreements. *See id.* at 2. One congressman has stated that "[t]he delay in passage of this legislation is a ticking time bomb for the Government securities market." *Id.* at 3 (quoting Rep. Glickman).

116. Mehle Letter, *supra* note 97, at 1-2.

117. Welles, *supra* note 1, at 74.

118. *Senate Hearing*, *supra* note 1, at 25-28 (statement of Anthony Solomon, President, Fed. Reserve Bank of N.Y.); Welles, *supra* note 1, at 74; Wall St. J., May 20, 1982, at 4, col. 1. Chase Manhattan Bank had acted as a clearing agent for Drysdale's transactions. Drysdale's counterparties, therefore, were not informed that they had entered into a repo with Drysdale. *Senate Hearing*, *supra* note 1, at 23-24 (statement of Anthony Solomon, President Fed. Reserve Bank of N.Y.); Federal Reserve Bank of N.Y., A Report on Drysdale and Other Recent Problems of Firms Involved in the Government Securities Market 3 (1982); M. Stigum, *supra* note 2, at 401. Although Chase Manhattan denied its obligation as a principal, *see* Welles, *supra* note 1, at 81, it paid Drysdale's obligations, in part to stave off a market panic. Wall St. J., May 20, 1982, at 4, col. 1. The default involving \$300 million would have been a major blow to the repo market. Welles, *supra* note 1, at 74; Wall St. J., May 20, 1982, at 4, col. 1. The effect would have been magnified had Drysdale's \$10

tial threat to the market¹¹⁹ due to repo dealers' high degree of leverage.¹²⁰ Second, critics argue that there is no proof that market contraction or rate increases will result from fear of the automatic stay.¹²¹ Although it is difficult to isolate the impact of any single event on the financial markets, some major institutions have left the market in response to the increased risk associated with a loan characterization.¹²² This trend towards market erosion has been forestalled, to some extent, by the expectation that Congress will enact legislative relief.¹²³ If such legislation is not forthcoming, more participants can be expected to leave the market. Statistics also indicate that dealers have been relying on more expensive bank loans for more of their inventory financing needs,¹²⁴ exerting upward pressure on interest rates.¹²⁵

Critics maintain further that the proposed legislation inequitably favors repo participants over other secured creditors.¹²⁶ Although the legislation provides special protection to repo participants, this benefit is incidental to the primary goal of safeguarding a critical financial

billion in assets not been liquidated, *Senate Hearing, supra* note 1, at 28 (statement of Anthony Solomon, President, Fed. Reserve Bank of N.Y.), but instead frozen in a bankruptcy court. *See id.* at 25.

119. Russo Letter, *supra* note 3, at 1.

120. SEC v. Miller, 495 F. Supp. 465, 471, 474 (S.D.N.Y. 1980); Welles, *supra* note 1, at 73-74.

121. *See* Cleary, Gottlieb, Steen & Hamilton, List of Treasury Concerns with Repo Bankruptcy Amendments that may be Raised at Fed Meeting November 29, 1982 at 1 (Nov. 29, 1982) (internal memorandum) (available in files of *Fordham Law Review*).

122. *See Bankruptcy Reform Hearing, supra* note 3, at 342-43 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); *id.* at 516 (statement of Investment Company Institute); *id.* at 312 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); Memorandum from Alfred P. Johnson to Mark Mackey, Ass't General Counsel, Investment Company Institute 1 (Nov. 22, 1982) (available in files of *Fordham Law Review*) [hereinafter cited as Johnson Memorandum]; PSA Release, *supra* note 19, at 1.

123. *See Bankruptcy Reform Hearing, supra* note 3, at 516 (statement of Investment Company Institute); *id.* at 314 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); *id.* at 342 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n).

124. *Id.* at 343 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); Johnson Memorandum, *supra* note 122, at 2.

125. *See Bankruptcy Reform Hearing, supra* note 3, at 315 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.); *id.* at 342-44 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n).

126. Mehle Letter, *supra* note 97, at 1.

market.¹²⁷ This overriding goal suggests, however, that the coverage of the legislation should be limited to major established markets.¹²⁸

Critics contend that the increased risk associated with a loan characterization is desirable because it promotes rigorous credit analysis, thereby preventing weak firms from obtaining too much credit.¹²⁹ The current level of risk, however, is so great that it threatens to destroy or severely erode the market.¹³⁰ The proposed legislation should be modified so that it reduces risk enough to ensure the market's smooth functioning yet leaves sufficient risk to encourage careful credit analysis by market participants. Moreover, the bankrupt should be protected to the furthest extent consistent with the preservation of the repo market.

The financial importance of the repo market warrants exempting repo participants from the automatic stay and preferenced provisions. Repo participants, however, should continue to be prohibited from enforcing "ipso facto" clauses, which declare a party in default solely on account of its bankruptcy.¹³¹ This proposal prevents a panicked mass liquidation that could further undermine the bankrupt's position,¹³² because the counterparty has little incentive to act on the estate's behalf once he has satisfied his own claim. The counterparty is therefore unlikely to conduct his negotiations or time the liquidation sale to the fluctuations of the market so as to maximize excess liquidation proceeds.¹³³ The estate should be allowed to unwind its transaction and to receive the benefit of its bargain as long as it fulfills its financial obligations under the repo. Such modified legislation would protect the repo markets without significantly undermining the Code policy of protecting the estate and promoting reorganization.

127. Volcker Letter II, *supra* note 12, at 3.

128. *Id.* at 2. The proposed legislation is limited to the major markets in U.S. government securities, bankers' acceptances and certificates of deposit. The legal status of repos on other types of assets, such as commercial paper or commodities would remain unchanged. *See id.*

129. *See Bankruptcy Reform Hearing, supra* note 3, at 315 (statement of Peter Sternlight, Executive Vice President, Fed. Reserve Bank of N.Y.).

130. *See id.*; *id.* at 337-38 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n).

131. This exception is analogous to the Code's treatment of executory contracts. Although the trustee must ordinarily cure any default prior to assuming a contract, 11 U.S.C. § 365 (1982), he need not cure default on account of an "ipso facto" clause. *Id.*

132. *See Kurtz Affidavit, supra* note 49, at 3-4. Moreover, preventing liquidation protects the estate from being charged with the consequential costs of liquidation. *See* U.C.C. § 9-504(1)(a) (1977).

133. *Id.* at 3.

The threat to counterparts of allowing the estate to close out the transaction is minimal. The capital in the transaction would not be frozen. Moreover, mark-to-market provisions could require the estate to deliver additional collateral within one day should the value of the collateral fall below a specified level. Such provisions would limit the risk to those situations in which one-day market swings exceed the requisite financial cushion. The continued presence of some risk and the threat to reputation from involvement with an insolvent entity should provide sufficient incentive for rigorous credit analyses.¹³⁴

CONCLUSION

The uncertain characterization of a repo in the event of a participant's bankruptcy has placed a cloud over the repo market.¹³⁵ A repo should be characterized as a secured loan and the securities subjected to the Code's automatic stay. The severe effects of subjecting repo participants to the automatic stay, however, could lead to widespread bankruptcies of financial institutions and a collapse of the government securities markets. Indeed, the mere possibility of application of the automatic stay threatens to cause a significant contraction of the repo markets. The critical financial importance of the repo market mandates legislation to exempt repo participants from the automatic stay. This Note endorses the legislation introduced in Congress to rectify the problem, with the proviso that repo participants should continue to be stayed from enforcing "ipso facto" clauses. Such a compromise provides adequate protection to the repurchase market while giving the estate an opportunity to unwind its transactions thereby facilitating the bankrupt's reorganization.

Gary Walters

134. See *Bankruptcy Reform Hearing*, *supra* note 3, at 516 (statement of Investment Company Institute) (importance of investor confidence).

135. *Id.* at 337-38 (statement of Thomas W. Strauss, Chairman, Gov't and Fed. Agency Sec. Div. of the Pub. Sec. Ass'n); *PSA Survey*, *supra* note 2, at 1; see *id.* at 5, 7.